

## Will International Trade Liberalization Enhance Economic Development?

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Almost a decade has passed since developing countries' delegates walked from the negotiating tables and protesters took to the streets in Seattle 1999, as they saw their interests and concerns at best neglected and at worst undermined. Since then, the industrialized countries have pledged to put development first, explicitly making it the aim of the following round started in Doha, Qatar, in late 2001, dubbed the "Doha Development Agenda." The on-going Doha of multilateral trade-negotiations at the World Trade Organization (WTO) ground to a halt in Cancun in 2003, experienced further hiccups in Hong Kong in 2005, and appears destined to stall for a while longer.

We briefly discuss its theoretical foundations to highlight the inappropriateness of pure trade theory for policy making and the often dubious empirical evidence of development gains from free trade, especially the efforts of the trade modeling community to advance the free trade agenda.

The case for trade liberalization rests on David Ricardo's theory of comparative advantage. Put forward in the early 19th century, he argued that England and Portugal could engage in mutually beneficial exchange of cloth and wine – whatever the respective industries' prices and productivities were. However, this argument requires a world of flexible exchange rates responsive to changes in goods markets, instantaneous full employment, and no factor mobility, meaning neither labor nor capital crosses borders. Quite obviously, especially in developing countries with chronic underemployment and volatile, pro-cyclical, capital flows, the latter two assumptions are generally not satisfied. Exchange rates, on the other hand, often are flexible, but believed to be determined primarily by asset markets, where they respond to changes in expectations about future growth and interest rates.

Even if these conditions are satisfied, Ricardo's theory and its 20th century "Heckscher-Ohlin-Samuelson" (H-O-S) version, after the three economists who popularized it, would run into problems, mainly because a large share of trade flows are not driven by factor endowments.<sup>1</sup> In Ricardo's original story, England focuses on producing cloth, and Portugal specializes in wine, where they both have relatively higher productivity. The modern version of H-O-S, in turn, relies on the idea that countries specialize in the industry that requires relatively more of its abundant factor of production – hills the sun shines upon for Portugal's port wine, and textile mills for England's tweed manufacturers. More recently, with the outsourcing boom, attention has turned to the fragmentation of the value chain – thus, vineyards in Portugal, but packaging in Morocco.<sup>2</sup>

Unfortunately, trade patterns do not conform to this theory. The overwhelming majority of trade occurs between countries that are very similar both in terms of

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<sup>1</sup> See Fontagne *et al.* (2006) for a discussion of horizontal as well as vertical intra- and inter-industry trade flows. Horizontal two-way trade within an industry is most important between developed, neighboring countries. Recently, with the rise of China, vertical differentiation between developing and developed countries has become more important.

<sup>2</sup> See Arndt (2001) for a representative exposition.

productivity and factor endowments, e.g. Toyotas and BMWs bought by Germans and Japanese respectively – both produced in economies with roughly the same levels of productivity, capital-intensity and real wages.

In order to explain such realities, economists introduced the idea of a "love of variety"<sup>3</sup> and, subsequently, so-called new trade theories,<sup>4</sup> which provide greater explanatory power – but, also justification for policy interventions such as tariffs and subsidies for strategically important, but still uncompetitive industries in developing countries. The gist of the argument is that trade flows among similar countries of similar goods, but different products, increase consumer utility due to the choices they have.

This literature, combined with Armington (1969),<sup>5</sup> lies at the heart of the large-scale policy models that dominate the trade policy agenda. A recent "advance" in modeling of this kind has been to attribute varying productivity levels to a population of heterogeneous firms, in an attempt to explain two important stylized facts. First, trade growth far outpaces output growth, which standard Armington models cannot show despite trade elasticities set at extraordinarily high levels. Second, exporting firms are a lot more productive than firms only servicing the domestic market. While these are very relevant questions, the literature tends to look for big trade gains from large trade responses following tariff removals.<sup>6</sup>

Luckily, for free trade advocates, this line of research never gained prominence in public and policy debates.<sup>7</sup> Instead, the assertion that free trade has secured a nation's, if not the world's prosperity and growth, by allowing each country to reap the gains of specialization, remains the conventional wisdom. Certainly, the correlation between growth and trade is strong. However, correlation does not imply causation: whether trade causes growth, or growth *of demand* causes trade, is an open question.

Keynes' followers – among them Thirlwall and Harrod – construed a trade theory<sup>8</sup> that explains, not unlike Keynes' (1936) domestic theory of effective demand, cross-border flows of goods and services as the result of the level (or rate of growth) of economic activity. Higher income in the US increases imports of, say, Hyundais, given their relative prices (and features) compared to Detroit cars, which are, as mentioned, determined, to a considerable degree, by a macroeconomic asset price – the exchange rate. Conveniently, these theories can be integrated with financial markets, where exchange rates are viewed as asset prices, and with underemployment as well as factor mobility, particularly of capital. Quite inconveniently though, such models produce much less gains from trade, and thus, cannot be drawn upon for free trade policy advocacy.

Another crucial dimension of trade theory and policy is the fundamental difference between economies of the developed and developing world. If the post-HOS

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<sup>3</sup> See the seminal article by Dixit and Stiglitz (1977).

<sup>4</sup> See, for example, the series of articles by Krugman (1980, 1981, 1983).

<sup>5</sup> Armington (1969) suggested a solution to the problems of multi-country, multi-sector trade modeling, stipulating that goods – say, a car from Germany and a car from Japan – trade off against each other, but are still "incomplete substitutes" due to their different product characteristics.

<sup>6</sup> See Bernard *et al.* (2003) and Bernard *et al.* (2007). An important precursor to this literature appears to be Stykolt and Eastman (1960).

<sup>7</sup> Deraniyagala and Fine (2001) make this argument in a critical survey.

<sup>8</sup> See Thirlwall (1979) for his original argument on balance-of-payments – constrained growth, and Naastepad (2006) and Barbosa (2006) for more recent Keynesian discussion of the same theme.

models, based on theories of industrial organization, help to explain trade between Japan and Germany, they do not seem well-suited for the analysis of trade issues relevant to Brazil or Kenya. Hans Singer and Raul Prebisch first identified the secular decline of primary commodity prices relative to manufactured goods while working for the UN over half a century ago. Ever since, the issue has been hotly debated.<sup>9</sup>

Logically though, the case seems clear: Even if Ricardo and Heckscher and Ohlin were right, the gains developing countries can make from specialization are eroded by falling relative world prices, transferring their productivity gains to consumers. If Kenya's firms do not manufacture at productivity levels comparable to the US, trade gains from mere love of variety appear a distant dream. The "periphery" gains much less as due to the intense competition over the production of 'generic' manufactures, the "core" captures more rents from their manufactured exports, the prices of which rise with technological advances thanks to the protection of intellectual property rights.<sup>10</sup> Not surprisingly, the prices of generics suggest low value-added in the South compared to specific, high value-added manufactures protected by strong intellectual property rights in the North.

Both the development literature and the monopolistic competition trade literature emphasize increasing returns, especially in manufacturing, usually stemming from falling average costs. The benefits from trade then do not rest on static allocative improvements, but on dynamic expansion induced by larger markets and greater specialization. The roots of these arguments can be found in Adam Smith, and more recently in Young (1928), Verdoorn (1949), Kaldor (1978) and Thirlwall (1980, 1992).

Kaldor and Thirlwall develop these ideas from a generally Keynesian perspective, according to which quantity adjustment and monetary factors matter, and thus overcome the crippling classical dichotomy of pure trade theory. Trade policy evaluated from this perspective suggests that the potential gains of trade liberalization are huge, but only if pursued from an existing industrial base, and complemented by industrial policy – otherwise, a country's (declining) purchasing power simply absorbs other countries' manufactures.

Thus, there is tremendous diversity in the literature on trade, trade liberalization and their effects on income, employment and the balance-of-payments as suggested by the preceding cursory review of various theoretical approaches to the question of how trade and development might interact. The following review of recent projected gains from further trade liberalization allows us to gauge some associated problems.

### **Gains From Trade Liberalization?**

The World Bank has been key in supporting the World Trade Organization in pursuing trade liberalization. The Bank's projections have been made on the basis of a computable general equilibrium (CGE) model of trade and production, the so-called LINKAGE model. Any CGE model is essentially a system of equations, each describing the "behavior" of firms, households, governments and so on, and LINKAGE happens to be a particularly large one with more than 40,000 equations. The effects of trade liberalization

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<sup>9</sup> See Ocampo and Parra (2006) and UN WESS (2006: chapter 3) for a recent modified reiteration, and Kellard and Wohar (2006) for a qualified refutation.

<sup>10</sup> The recent commodity price boom, including the ethanol boom, does not disprove the case.

are estimated by removing tariffs and subsidies, which enter the price equations effecting demand decisions.

However, the *behavioral functions* are based on theory, and all too often, and certainly in the case of LINKAGE CGE models, rely on dubious simplifications, incomplete information and rigid comparative statics – ignoring transition, implementation and adjustment costs.<sup>11</sup> Like so much of international trade theory, the models make other problematic assumptions such as full or fixed employment,<sup>12</sup> while focusing only on the effects of price changes. Trade liberalization is also likely to cause unemployment or lower incomes in previously protected, internationally uncompetitive activities. Studies of the effects of trade liberalization also do not point to significant employment gains (e.g. Ocampo, Jomo and Khan 2006, especially the chapters by Cornia, Lee and Hoekman & Winters). Unfortunately, such CGE models rely on poor theory (Ackerman and Nadal, 2004), overestimate the benefits and neglect the costs of free trade.

World Bank (2005) projections of the benefits of complete trade liberalization (Anderson and Martin 2005) have been significantly revised downwards from earlier estimates just a few years before. More than 70 per cent will accrue to rich countries, including two-thirds of global benefits from agricultural trade liberalization, and even more for non-textile manufacturers. More than two-thirds of the static gains to developing countries from trade liberalization accrue to Argentina, Brazil and India in the case of agriculture, and China as well as Vietnam in the case of textiles.

As full trade liberalization is not under negotiation in the Doha Round, Anderson and Martin (2005) also considered several possible Doha Round scenarios of trade liberalization. Their most realistic scenario projects welfare gains in 2015 of \$96 billion, a third of the estimated gains of full trade liberalization, with much greater gains for the rich countries, which stand to gain \$80 billion, or 82% of the potential gains of full liberalization, compared to \$16 billion for developing countries, or 18% of the potential gains.

Comment [SCL1]: check

Global benefits have fallen by two-thirds in other estimates, while gains for developing countries have dropped by four-fifths. Contrary to the claims of advocates of agricultural trade liberalization, eliminating agricultural and export subsidies in the OECD would cause net welfare losses in developing countries! The supposed gains from agricultural trade liberalization are likely to bring greater benefits to a few rich agriculture exporting countries, rather than to most of the developing world (Anderson, 2002), let alone the bulk of the poor. Countries already enjoying more preferential market access – such as Mexico (through NAFTA), Central American countries (via CAFTA), most African countries and some of the other least developed countries – are likely to lose most from trade liberalization.

Comment [SCL2]: same?

Other estimates suggest even more modest gains, with the ostensible gains and their impacts on poverty and inequality very sensitive to assumptions, definitions and measurement (e.g. Ackerman, 2005). Another CGE model-based Doha agricultural trade liberalization scenario finds that rich countries would gain \$19 billion, China and South

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<sup>11</sup> See Stiglitz and Charlton (2004).

<sup>12</sup> See Ackerman (2005).

Asia \$1 billion each, while other developing countries would lose \$3 billion (Bouet *et al.* 2004).

The likely contribution of such scenarios to poverty reduction varies greatly and is further limited by the declining contribution of economic growth to poverty reduction due to rising inequality. In view of the historically critical role of trade policy – as opposed to trade liberalization – for economic development, the consequences of trade liberalization for sustainable development are dubious (Chang 2007; Reinert 2007).

Ackerman (2005) and Taylor and von Arnim (2006) have criticized the theory and methodology underlying these estimates. For example, the **Armington trade specification** over-emphasizes the potentially benefits of liberalization and introduces unknown, but possibly huge biases. The Bank assumes trade elasticities greater than those supported by econometric evidence, thus exaggerating welfare gains and underestimating adverse terms of trade trends. The Bank model's detailed disaggregation and very complex architecture obscures what the model is actually doing, and distracts policy makers as well as the informed public from its fundamentally flawed assumptions – among them full employment, flexible exchange rates and balanced trade. Furthermore, the Bank assumes uniformity in tastes and equal access to resources, and postulates that all, including the least developed countries' – governments will be able to replace lost tariff revenue by taxing households, and thus, keep its budget in balance.

Comment [SCL3]: ?  
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Using a simplified, but structurally similar model, Taylor and von Arnim (2006) show to what degree trade liberalization simulation results depend on initial assumptions. Allowing a bit more realism – unemployment, for example – makes clear that Africa will *not* gain, on balance, from trade liberalization. Their exercise suggests that Sub-Saharan Africa is likely to experience welfare losses, even assuming the absence of macroeconomic shocks, the region is likely to experience a worsening trade balance, debt problems are likely to increase, and any short term gains in employment and GDP are likely to evaporate quickly under the pressure of such strained balances.

Even though his model details differ, Kraev's (2005) "alternative" analysis of the effects of trade liberalization on GDP has a methodology and aims compatible with Taylor and von Arnim. Endogenizing output, employment and the current account in a CGE framework allows him to estimate future risks or past losses due to trade liberalization. As soon as the current account and employment are endogenized, trade liberalization induces macroeconomic volatility – with mostly negative effects for developing regions.

Polaski (2006) introduces unemployment and separates agricultural labor markets from urban unskilled labor markets in an otherwise more "standard" CGE-model, and finds (1) that global gains from further trade liberalization are very modest, (2) that – in sharp contrast to the World Bank's full employment models – developing countries' gains overwhelmingly stem from market access for manufacturing, and (3) that the largest gains accrue to countries such as China, while the poorest (in Sub-Saharan Africa) are net losers.

Very little of the trade liberalization literature discusses the dynamic and longer term consequences of trade liberalization. However, recent attempts to persuade developing countries to accept further trade liberalization have led to new inducements in the form of 'aid for trade' (A4T). Trade liberalization advocate Jagdish Bhagwati (2005) has made three revealing arguments for A4T. First, to compensate governments for their

loss of tariff revenue, which can account for up to half of total tax revenue in the poorest countries. Second, to compensate producers, workers and others for the loss of uncompetitive production capacities in agriculture, industry and even services. Third, to develop new internationally competitive productive capacities and capabilities. Such recognition of the need to compensate for the loss of revenue and economic capacities as well as the high and uncertain costs of developing alternative economic capacities underscores the limitations of the comparative static arguments associated with simplistic traditional trade theory.

### **The Reality of Negotiations**

The reality of negotiations presents a different set of challenges for developing countries. The conclusion of the Uruguay Round of trade negotiations saw the World Trade Organization (WTO) replace the General Agreement on Tariffs and Trade (GATT), with considerably enhanced powers, but also a significantly broadened scope of ostensibly trade related matters. The WTO trade agenda has broadened from GATT's focus on manufactures to include services while giving greater attention to agriculture. Not only has trade liberalization been extended to services and strengthening intellectual property rights, but the economic size and weight of a country as well as the limited experience and expertise of their lawyers make it difficult for poor countries to get effective representation. The doors of the infamous "Green Room," where key issues are 'settled' before they enter the agenda for multilateral decisions have only recently been opened for a handful of big developing countries.

Perhaps most importantly, membership of the WTO involves a 'single undertaking' requiring compliance with all WTO agreements – unlike the previous option under GATT of signing up on an agreement by agreement basis. The WTO has also created and strengthened processes and mechanisms for dispute settlement that have tended to favour corporate interests and rich country governments who can better afford the legal and lobbying resources to pursue their interests. The new rules for dispute settlement also allow for retaliation on a different front than the source of the grievance.

Historically, there has been a great deal of self-interest – and hypocrisy – in the advocacy and pursuit of trade liberalization. For example, many critics argue that the European Union's declared trade liberalization objective of 'everything but arms' has, in practice, involved 'everything but farms.'

Meanwhile, liberalization of services has mainly involved financial services, rather than construction or maritime services where developing countries are better able to compete. Although the proposed Trade Related Investment Measures (TRIMs) were not fully adopted, the OECD's MAI (Multilateral Agreement on Investment) was aborted, and investment liberalization is no longer on the Doha Round agenda, preparations for an MIA (Multilateral Investment Agreement) with similar objectives are believed to be continuing, although not imminent. Meanwhile, the Agreement on Trade Related Intellectual Property Rights (TRIPs) has given transnational corporations greater (monopoly) powers than provided by WIPO, the World Intellectual Property Organization.

The last decade has seen a proliferation of thousands of bilateral investment treaties (BITs), their multilateral counterparts as well as increasingly significant investment and intellectual property rights components of ostensible free trade

agreements, both bilateral and multilateral. Meanwhile, regional free trade arrangements as well as bilateral free trade agreements – both often referred to as FTAs – may inadvertently serve to slow down multilateral trade liberalization although they are sometimes misleadingly rationalized as building blocks for the latter, or as intended to accelerate progress in that direction. As multilateral negotiations are dragged out, a recent agreement between the EU and African, Caribbean and Pacific (ACP) countries serves as a prime example of the unequal playing field not only in trade, but even the negotiations about it. Oxfam (2007) warns that “these deals may devastate livelihoods and undermine future growth” as the EU asked for tremendous concessions in return for extending preferential tariff regimes for imports from ACP countries.

## Conclusions

Contrary to the conventional wisdom that “free trade” is always good for development, economic theory offers a wide array of views on the issue, particular in connection with the development of mainly agricultural economies. The issue has recently been emphasized, as developing countries try to maintain “policy space” amidst a tightening stranglehold of multilateral rules and regulations.<sup>13</sup>

Standard models used to estimate how the benefits from further liberalization are distributed are flawed in important ways, and ignore the risks of labor displacement, economic downturn and increasing debt in the developing world.

Unfortunately, things do not look better in practice. Widely recognized power imbalances in the WTO also undermine developing countries’ potential “gains from trade”. Many of the poorest countries are already expected to be net losers following further trade liberalization, and much more than “Aid for Trade” will be needed to ensure that the Doha round is truly developmental.

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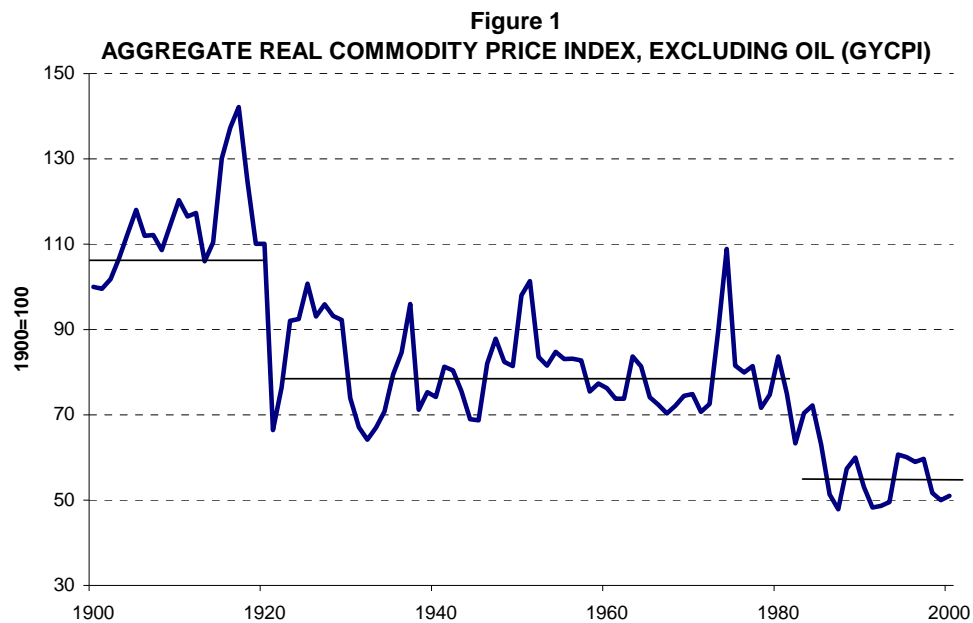
<sup>13</sup> See Rodrik (2007), Ocampo *et al.* (2006) and Gallagher (2005).

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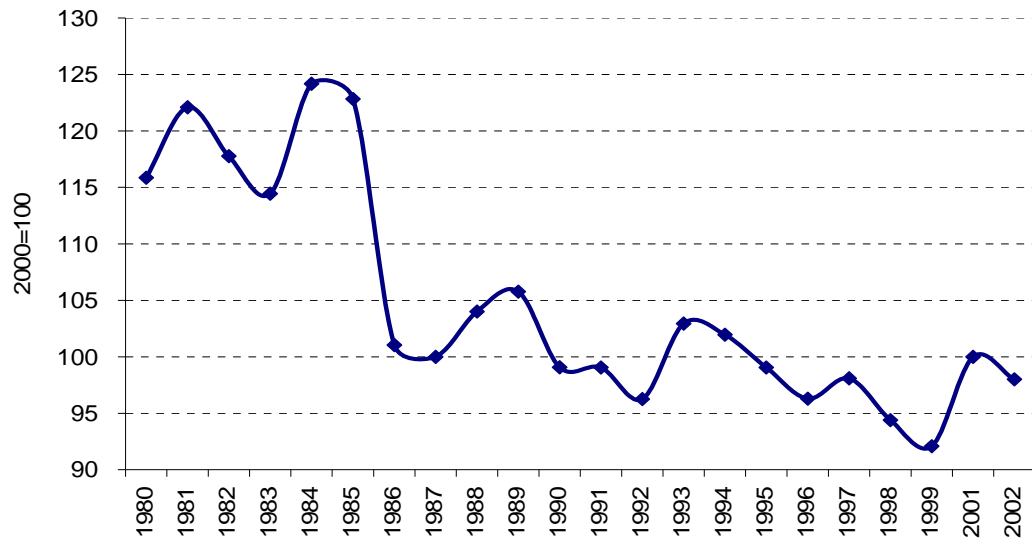
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## Figures



Source: Grilli and Yang (1988); Ocampo and Parra (2003).

Unit value of manufactures exported by developing countries relative to manufactures exported by developed countries



Source: Parra, based on UN commodity statistics